Q1 Perspectives: Cyclical Bear Market or Structural Bull Market?

After surviving the technical definition of a bear market (a close on close drop of 20%) by a whisker during the last quarter of 2018, large cap U.S. equities staged an impressive 21%+ rally from the market bottom in Q4 thru the peak of the first quarter of 2019. Global equities in a similarly correlated fashion rallied over 18% from the Q4 bottom, after barely missing their own bear markets during 2018 by the smallest of margins.

Equities	Q1 2019
S&P 500	13.6%
MSCI ACWI IMI	12.4%
MSCI EM	9.6%

Fixed Income	Q1 2019
Barclays US Agg	2.9%
Barclays Global Agg	2.2%
Barclays US High Yield	7.3%

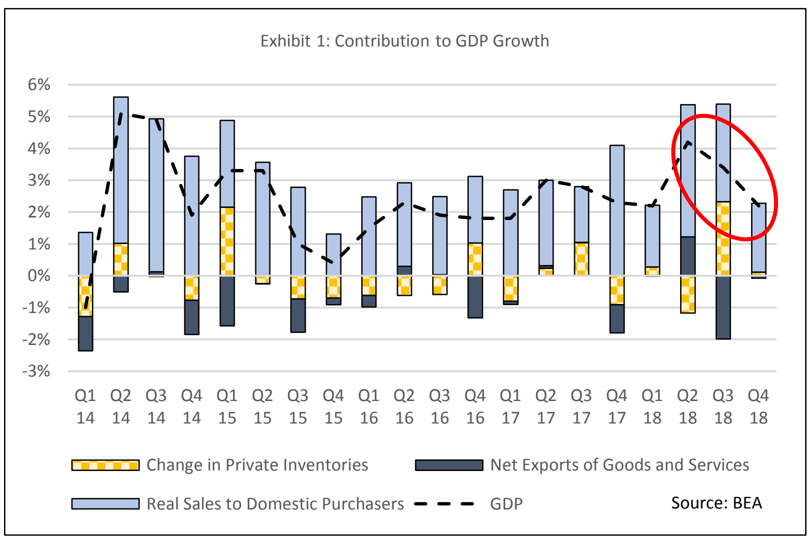
While we are always in support of standardizations and definitions that clearly delineate one phase from another, as well as being students of technical analysis, we have never found much added value for our investment philosophy in identifying and labeling various market phases with such artificially defined terms as "cyclical bear markets" or "structural bull markets." And although we do spend a significant amount of our time attempting to delineate one phase of an economic cycle from another and knitting them to various definitions of over and under valuation for financial assets, we do so on a relative basis at all times. While one needs to be mindful of the "this time is different" arguments, cycles and markets are constantly evolving, and success necessarily requires periodic readjustments of definitions that can and do meet the new "regime in the markets."

From where we stand, a standard 20% drop in equities which is commonly referred to as a "cyclical bear market" will not necessarily involve the completion of a phase in the markets that alters our view of risk assets being under or over valued. Similarly, and on the upside are Wall Street's three favorite words – "structural bull market". But one simply needs to review the definition of "structural" as defined by strategists a bit more carefully to realize that the Dow Jones Industrial Average has been in a "structural bull market" since March of 1904! As long term investors, we struggle to understand how this in anyway can and should impact our asset allocation decisions as it relates to risky assets.

So, given our perspectives coming into 2019[1] and with the events of Q1 out of the way, where do we find ourselves today?

The Global Economy:

The final release of Q4 GDP in the U.S. with its meaningful downward revision from earlier releases put one of the final nails in the coffin for the above average growth story of the Tax Cuts and Jobs Act of 2017 (TCJA). Despite the fact that overall growth during 2018 was near 3.0%, once we account for the largest expansion in government spending since the great recession and the largest accumulation of inventories in years which occurred during Q3, the direct impacts of the TCJA were really only felt in the first half. It has been a fast return to trend growth since then (see exhibit 1). Why one of the last nails? Because the payback from the artificial above-trend growth in Q2 and to some extent Q3 is still ahead of us. We expect Q1 2019 growth to be no more than 1.5%, followed by a small rebound to 2.2% in Q2, and average just 1.6% during the second half. For 2019 we expect full year growth of just 1.7%, and merely 1.2% for 2020.



[1] ACIMA Private Wealth 2019 Outlook

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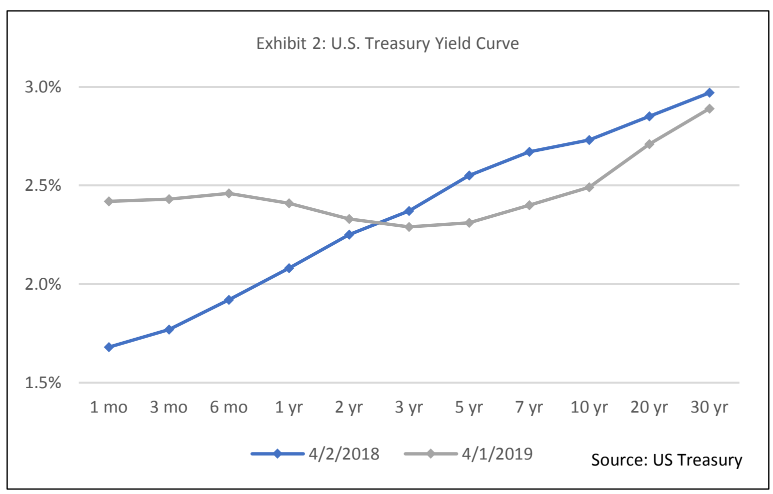
In China, the mid-cycle growth phase which we typically refer to as the "sweet spot" of the expansion, and which we anticipated starting during the first half of 2019 has found some serious challenges from the trade dispute with the United States. While China's manufacturing surveys remain in contractionary territory and at levels not seen since the 2016 slowdown (cycle ending from our perspective), services remain well above their 2016 lows. In addition, new orders economy-wide rebounded into expansionary territory in February, in line with easing financial conditions. Our forward indicators are also pointing to a second consecutive quarter of strength in fixed asset investment in Q1 on the back of stronger than expected numbers in Q4. We remain above consensus in our growth forecast for China, and continue to expect 6.4% for 2019.

On the topic of the trade dispute between China and the U.S., we continue to believe that what is achievable will be more in line with form than substance. At this stage, exhaustion has become the dominant barrier to a final agreement (negotiators are reportedly going through an agreement line by line seeking adjectives and verbs to take out or add in that may or may not sound marketable to their domestic audiences). The U.S. administration cannot end the dispute without something to declare victory with, even if it scratches a surface that in the end is not scratchable. The question is how willing will President Xi be in handing a victory to President Trump, even a spurious one?

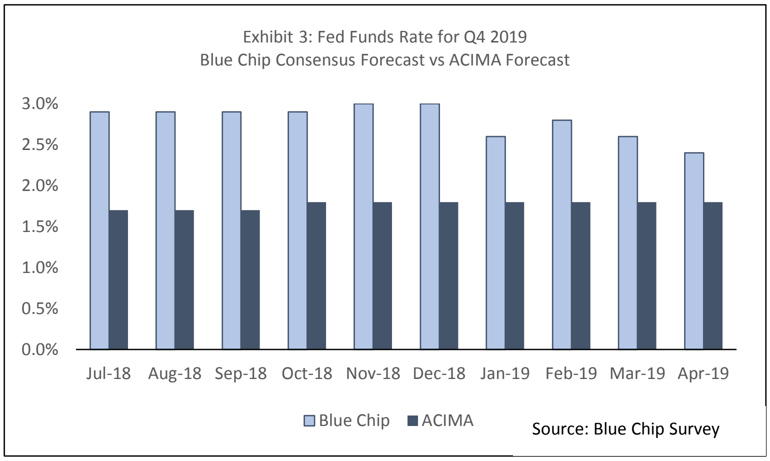
In the Eurozone, the sharp drop in exports during the second half of 2018 significantly weakened overall growth in the common currency zone. Germany almost fell into a technical definition of a recession, while Italy was not so lucky (though weaker government consumption was the trigger in Q4). France, the Netherlands, and Spain carried a significant amount of the load which ultimately kept growth above the zero mark for the zone. Our belief up to this point had been that the E.U. was slightly lagging the U.S. in its growth profile and business cycle and a relative period of outperformance was likely in either 2018 or 2019. That optimism has been eroded by what increasingly looks to be a difficult Q1, especially for Germany. As such we believe the economy of the zone has peaked for the cycle and recessionary risks for the area have increased substantially heading into 2020.

If only a do over was possible in the United Kingdom. If only the Winter of 2016 could be brought back and Prime Minister David Cameron would have resolved the infighting within his cabinet and party the more efficient way and kept the citizenry out of it. If only the British government and parliament today would take lessons, and either accept the consequences of a weaker hand or permit the citizenry another voice. Rarely in the modern history of western democracies does one see such paralysis in leadership. At this stage in the game, parliament has two simple choices but is unwilling to believe as such: vote in favor of what Prime Minister May has agreed to with the E.U. completely, or in part and remain subject to E.U. rules in other parts until some future unknown date (a.k.a. leaving the E.U. without really leaving it), or simply to revoke article 50 and remain in the union. In the meantime, growth, investment, and employment trends will weaken further both cyclically and structurally, placing the U.K. on the top of our list of North Atlantic economies in terms of risks for recession either later this year or 2020.



Financial Markets:

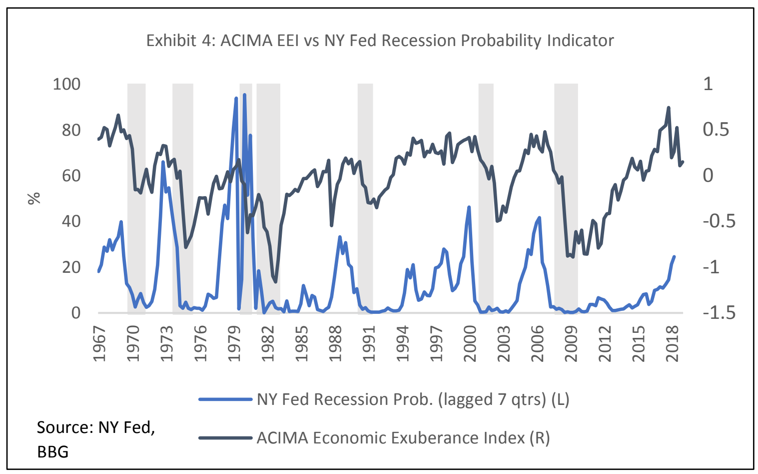
As the first quarter comes to an end, amongst the members of the Eurozone, Italy now remains the odd man out when it comes to negative yielding 2-year government notes. Further out to seven-year maturities, Germany, France, and the Netherlands now sponsor negative yields. Germany remains negative out to 10-year maturities. Japan, Switzerland and Sweden also have negative yielding term structures through at least 5-year maturities. Australia, Canada, and the U.S. have positive term structures but inverted yield curves through 5-year maturities (see exhibit 2).



In the U.S., forward markets have substantially increased the possibility of rate cuts as the next likely move by the Federal Reserve, which remains one of our most out of consensus calls (though the consensus seems to be drifting in our direction by the month, evidenced in exhibit 3). Yields on the 10-year Treasury Notes have dropped by 84 bps since early November. All the while, equity markets have rallied, while spreads across all credit term structures have tightened substantially since late December.

While the turnaround in their perspectives on the economy at both the ECB and Federal Reserve since the latter half of 2018 is brow-raising, it is the adamant refusal of both institutions to be genuine in the sense of acknowledging the role played by the recent volatility in the global equity and credit markets in their rather quick transition to a more dovish stance that is truly remarkable to us.

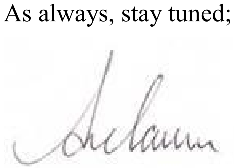
Have these recent turnarounds and dovish stances resurfaced the idea of a central bank "put" for financial markets – pushing interest rates down, tightening credit spreads, and rallying equity markets to within a short distance of their 2018 highs, thereby keeping exuberance elevated? It would be foolish not to assume so. It would be equally if not more foolish to ignore the larger and more important action of investors in the bullish flattening of yield curves, especially those in the U.S., and the contractionary/recessionary signals it is sending for the economy in general and corporate earnings in particular (see exhibit 4).



Signals from the bond markets, gradually lowered earnings projections from consensus, and lower growth projections from central banks give us pause as to the momentum going forward. How much should we trust a rally in the global equity markets driven by multiple expansion? Not much.

We continue to remain cautious and conservative on risky assets outside of select developed and emerging markets where value exists and the economic cycle remains favorable. For the rest of the world in general and theE.U and U.S. in particular, the combination of high equity market valuations, fiscal balances that are fast moving in the wrong direction, bubble like corporate leverage, payback from ill-timed tax cuts and regulatory actions, and coming trade tensions between the U.S. and the E.U. are sufficient enough that the prospects of earning 2.4%+ from zero duration cash and remaining patient are quite attractive to us.

As always, stay tuned;



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April 3rd, 2019

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